WTO Panel Says US Tax Incentives for Aircraft Are Prohibited Subsidies

On November 28, 2016, a World Trade Organization ("WTO") Panel ("Panel") issued its report in *United States – Conditional Tax Incentives for Large Civil Aircraft*.[1] The dispute concerned seven tax-related incentives for civil aircraft ("aerospace tax measures") provided by the state of Washington in the United States. The European Union claimed that the availability of the tax incentives was conditional on "the initial siting of a 'significant commercial airplane manufacturing program' in the state of Washington."[2]

The European Union said that the Washington State tax incentives constituted a prohibited subsidy in the sense of Article 3.1(b) and 3.2 of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement") on the ground that the incentives were contingent on the use of domestic over imported goods. The Panel found in favor of the European Union as it held that the favorable tax rate for the manufacturing or sale of commercial airplanes is a prohibited subsidy within the meaning of the SCM Agreement.

The Panel's decision is one in a long series of disputes between the United States and the European Union on the granting of subsidies to their respective large civil aircraft manufacturers—Boeing Co. and Airbus Group SE. At the time of writing, the WTO's Appellate Body is dealing with the appeal brought by the United States and the European Union in *EC – Aircraft (21.5)*. Another WTO panel is expected to issue its report in the compliance proceedings in *US – Large Civil Aircraft (Second Complaint)* in early 2017. Importantly, as the Panel noted, the measures at issue in this dispute amended the tax measures that are at issue in that initial proceeding. It is expected that the United States will also make use of its right to appeal the Panel's findings in this dispute.

The Panel's Findings With Respect to the Tax Incentives as Constituting a Subsidy within the Meaning of the SCM Agreement

The European Union challenged the existence of seven aerospace tax measures, including reduced business and occupation ("B&O") tax rates, B&O tax credits, exemptions from sales, use, leasehold excise, and property taxes.[3] The European Union argued that these tax measures constituted prohibited subsidies as they are contingent upon the use of domestic (US) goods over imported goods. It considered that this contingency arose from two "siting" provisions contained in "Engrossed Substitute Senate Bill 5952 ("ESSB 5952").

At the outset it is important to note that the WTO Agreement does not prohibit WTO Members from granting subsidies *per se*. In principle, subsidization is permitted, but the

SCM Agreement provides WTO Members with tools to address the injurious effects of subsidies in the form of countervailing measures. Nevertheless, Article 3 of the SCM Agreement also explicitly prohibits two types of subsidies that its drafters considered to be distortive of trade: (i) subsidies contingent upon the export performance of the recipient and (ii) subsidies contingent upon the use of domestic over imported goods by the recipient. This dispute deals with the second type of prohibited subsidies.

The Panel began its analysis by determining whether, as the European Union had claimed, the aerospace tax measures constituted subsidies in the sense of the SCM Agreement. Generally speaking, a subsidy is found to exist if there is a financial contribution by a government or public body that confers a benefit on the recipient.

In a highly systematic and structural fashion, the Panel analyzed each of the seven measures and concluded that each of these measures constitutes a financial contribution because "government revenue that is otherwise due is foregone or not collected."[4]

In the next step of its analysis, the Panel determined whether through the existence of that financial contribution a "benefit" was conferred upon the recipient. It applied the standard test for this determination and assessed whether the recipient of the subsidy was "better off" than it would otherwise have been, absent the financial contribution. The Panel briefly reviewed some of the case law on this issue and considered, in particular, that "by virtue of foregoing revenue, that departure from the norm means that the taxpayers that are subject to the government's normative departure owe less than they otherwise would under the "normal" taxation rules.[5] The Panel also referenced the panel's findings in *US – Large Civil Aircraft (2nd Complaint)*, which had concluded that "the relevant tax break is essentially a gift from the government … and it is clear that the market does not give such gifts."[6] Ultimately, the Panel concluded that each of the aerospace tax measures conferred a benefit upon its recipient. Notably, the analysis of the Panel might at times be considered as conflating the concepts of "financial contribution" and "benefit."[7]

In addition to establishing the existence of a "financial contribution" and a "benefit," for a subsidy to be found to exist, it must be assessed whether that subsidy is "specific" in the sense of Article 2 of the SCM Agreement. However, as paragraph 3 of that provision considers each prohibited subsidy to be "specific" *per se* – and since the European Union only challenged the existence of "prohibited subsidies" – the distinct element of "specificity" was not addressed by the Panel.

Whether the Aerospace Tax Measures Constituted *Prohibited* Subsidies Within the Meaning of the SCM Agreement

Instead, the Panel proceeded directly to a determination as to whether the tax measures constituted *prohibited* subsidies in the sense of Article 3 of the SCM Agreement. The Panel first established the appropriate legal standard under that provision by interpreting the terms "contingency," "over," "use" and "goods."[8] It found that the term "contingency" has the same meaning in both subparagraph 3.1(a) and subparagraph 3.1(b) of the agreement. The term "over" was found by the Panel as indicating that any subsidy "that is conditional on the use of domestic goods in preference to (or "instead of" or "rather than") imported goods" is prohibited. "Use" was interpreted as being broad enough to also cover the "consumption" or "employment" of domestic goods over imported goods, and not merely "the

consumption of goods … as inputs into a production process," as the United States had argued. Finally, the term "goods" was interpreted as being synonymous with "products."

The European Union had alleged that the aerospace tax measures were *de jure* and *de facto* contingent upon the use of domestic over imported goods. Its *de jure* claim "would be made on the basis of the express terms of the text of the measure or by necessary implication therefrom," whereas its *de facto* claim "would have to be inferred 'from the total configuration of facts constituting and surrounding the subsidy grant, including the design, structure and modalities of operation set out in the measure.'"[9]

In order to establish the existence of *de jure* contingency the Panel examined whether the First Siting Provision and the Second Siting Provision in the text of ESSB 5952 read individually or together make the granting of the subsidy contingent upon the use of domestic over imported goods. The Panel rejected these *de jure* claims. It noted that the siting provisions "on their face" provide for the "siting" of certain *manufacturing activities* within the state of Washington as a condition for the enjoyment of tax benefits, but that the provisions "do not make the receipt or continued enjoyment of subsidies dependent on refraining from using imported *products*."[10]

The Panel then continued its analysis by examining the potential *de facto* import substitution contingency of the aerospace tax measures. It observed that there are no precedents on the criteria that would have to be used. It opted to proceed on the basis that it would need to determine the manner in which the measures were "structured, designed, and operate." The Panel focused on the B&O aerospace tax rate for the manufacturing or sale of commercial airplanes under the "777X programme." It found that the fact that this tax rate would be lost if Boeing used wings produced outside of Washington State, even if it maintained production of such wings in Washington State, made the programme contingent upon the use of wings made in Washington State.

On this basis the Panel concluded that the United States had acted inconsistently with its WTO obligations by violating Article 3.1(b), and by necessary implication, Article 3.2 of the SCM Agreement. Notably, in respect of "prohibited subsidies," the SCM Agreement mandates the Panel to rule that such a subsidy should be withdrawn without delay. Consequently, the Panel recommended the United States withdraw the subsidy without delay and within 90 days.[11] The Panel refrained from making suggestions concerning steps that the United States could take in order to implement the Panel's recommendation.

Relevance of the Findings in the Panel Report

The importance of the Panel report in *US – Tax Incentives* is twofold. First, the Panel report presents a new interpretation of Article 3 of the SCM Agreement relating to the conditionality of a subsidy scheme upon the use of domestic over imported goods. Considering that this is the first time in the Airbus-Boeing saga that the existence of prohibited subsidies has been established, it will be interesting to see whether, and if so how, the United States will give effect to the Panel's recommendation. Second, the Panel report presents the next chapter in the long-running Airbus-Boeing saga that is being written in the WTO dispute settlement system. It is expected that this Panel report will also be appealed, adding to the long list of disputes over subsidies in the large civil aircraft sector that are being fought out in Geneva.

For more information about the topics raised in this Legal Update, please contact one of the following Mayer Brown lawyers and professionals.

Author

Dylan Geraets
Legal Professional/Consultant,
Trade & Customs, Brussels
+32 2 551 5948
dgeraets@mayerbrown.com

US Contact

Duane W. Layton
Partner, Washington DC
+1 202 263 3811
dlayton@mayerbrown.com

Europe Contact

Nikolay Mizulin
Partner, Brussels
+32 2 551 5967
nmizulin@mayerbrown.com

Asia Contact

Cecil Leong
Chief Executive Officer, Asia Pacific, Mayer Brown Consulting, Singapore (MBC)
+65 6327 0254
cecil.leong@mayerbrown.com

Brazil Contact

Eduardo Molan Gaban
Partner, São Paulo (T&C)
+55 11 2504 4639
egaban@mayerbrown.com

Endnotes

1 Panel Report, *United States – Conditional Tax Incentives for Large Civil Aircraft*, WT/DS487//R, 28 November, 2016 (hereinafter: *US – Tax Incentives*). https://www.wto.org/english/tratop_e/dispu_e/487r_e.pdf
2 Panel Report, *US – Tax Incentives*, para. 7.3.
3 Panel Report, *US – Tax Incentives*, para. 7.2. The measures are described in detail in paras. 7.17-7.26.
4 Panel Report, *US – Tax Incentives*, para. 7.157.
5 Panel Report, *US – Tax Incentives*, para. 7.160.
6 Panel Report, *US – Tax Incentives*, para. 7.161.
7 Panel Report, *US – Tax Incentives*, para. 7.163. The Panel itself acknowledged this and considered that it is "not precluded from using the same factual elements" for determining the existence of both elements of a subsidy.
8 Panel Report, *US – Tax Incentives*, paras. 7.202-7.225.
9 Panel Report, *US – Tax Incentives*, para. 7.170.
10 Panel Report, *US – Tax Incentives*, para. 7.315.
11 Panel Report, *US – Tax Incentives*, para. 8.6.